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IMPACT OF U.S. TAX REFORM ON CANADIAN MULTINATIONALS

— Reuben Abitbol and Michael N. Kandev Davies Ward Phillips & Vineberg LLP, Montreal[1]

Introduction

The United States is Canada's largest trading partner, accounting for over 75% of Canadian exports[2] and nearly half of all Canadian direct investment abroad.[3] Not surprisingly Canadians are watching closely the whirlwind U.S. tax reform based on the Trump administration's plan presented on September 27, 2017, which has unfolded surprisingly rapidly over the past month.

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[1] The authors would like to thank their colleagues Gregg Benson and Nat Boidman for their input into this article. Any errors or omissions are the responsibility solely of the authors. This article reflects the state of the Proposals as of December 14, 2017 at 9:00 a.m.

[2] Total of US$296.5 billion representing 76.2% of total Canadian exports (2016): http://www.worldstopexports.com/canadas-top-import-partners/

[3] Total of C$392 billion representing 47.5% of total Canadian FDI (2016): http://www.international.gc.ca/economist-economiste/statistics-statistiques/outward_inward-actifs_passif.aspx?lang=eng

On November 2, 2017, the House Republicans[4] introduced the *Tax Cuts and Jobs Act*[5] which was approved in record time by a majority of the House of Representatives on November 16, 2017. Then, on December 2, 2017, the Senate approved its own version of the House Bill (the "**Senate Bill**", collectively with the House Bill, the "**Proposals**"), thus paving the way for the Joint Conference Committee on Taxation (" **JCT**") to begin its reconciliation process.[6]

The Proposals, if enacted, will represent the most significant overhaul of the U.S. tax system since the 1986 enactment of the *Tax Reform Act* under the Regan administration.[7] Much has already been written about the Proposals.[8] Accordingly, this article does not intend to provide a comprehensive summary or analysis of the reform, but, instead, focuses on those aspects of the Proposals that may most directly affect Canadian multinational enterprises ("**MNEs**") doing business in the United States.

Corporate Tax Rate Reduction

The reduction of U.S. federal corporate tax rate has been one of the centerpieces of the Proposals. Since the 1986 U.S. tax reform, the top federal marginal corporate tax rate has been set at 35%. The average combined national and sub-national U.S. corporate tax rack rate is close to 40%, which places it as the highest among OECD countries[9] and third highest in the world after the UAE and Chad.[10] By comparison, the average combined Canadian corporate tax rate of 26.7%[11] has historically compared very favourably. Obviously, this state of affairs has made corporate tax minimization planning highly attractive to Canadian (and other) MNEs investing in the United States.

Now, if the Proposals are enacted, this is set to dramatically change. Both the House Bill and Senate Bill originally proposed a dramatic drop of the federal corporate tax rate from 35% to 20%.[12] On December 13, 2017, the JCT announced the new agreed-upon corporate tax rate of 21% beginning in 2018. However, this figure taken in isolation is deceptive and must be qualified.[13] Many U.S. states[14] and some U.S. cities[15] impose their own corporate income tax. For example, in Philadelphia there is a city tax on corporate profits charged at 6.39% in addition to Pennsylvania's state corporate tax imposed at 9.99%. As a result, the new overall corporate tax in Philadelphia could be as high as 33.94%, which remains extremely high by OECD standards. Therefore, absent other measures, corporate minimization strategies would still remain highly desirable. This brings us to the general and more specific anti-base erosion measures that are found in the Proposals.

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[4] Pursuant to the "Origination Clause" in the *Constitution of the United States*, all revenue-raising legislation must originate in the House of Representatives, not the Senate.

[5] U.S., HR Res 1, *Tax Cuts and Jobs Act*, 115th Cong, 2017 (the "**House Bill**").

[6] On December 4, 2017, the House voted in favour of proceeding with the JCT (222-192), and named the following conferees: Congressmen Brady (R-TX), Johnson (R-TX), Nunes (R-CA), Neal (D-MA) and Lewis (D-GA). Similarly, on December 6, 2017, the Senate also voted in favour of proceeding with the JCT (51-47), and named the following conferees: Senators Hatch (R-UT), Grassley (R-IA), Crapo (R-ID), Wyden (D-OR) and Stabenow (D-MI).

[7] *Tax Reform Act*, Pub L No 99-514, 100 Stat 2085 (1986). In that regard, see N. Boidman and G.J. Gartner, *US Tax Reform – The Canadian Perspective*, (CCH Canadian Limited, 1987).

[8] See, for example, G. Benson, N. Boidman & P. Glicklich, "U.S. Tax Reform in a Canadian Context", Tax Management Int'l J. Vol. 46, No. 12 (December 8, 2017).

[9] 2017 OECD statistics are based on a 38.91% combined rate: http://stats.oecd.org/index.aspx?DataSetCode=TABLE_II1.

[10] Tax Foundation, Corporate Income Tax Rates around the World, 2014: https://taxfoundation.org/corporate-income-tax-rates-around-world-2014#_ftn1.

[11] *Supra* note 9.

[12] The Senate plan cuts the corporate tax rate effective in 2019, while the House plan does so in 2018. Prior to the Senate's vote on December 2, 2017, Senator Marco Rubio (R-Florida) introduced a last-minute amendment that would cut the corporate rate of tax to 20.94% instead of the 20% rate currently contained in the Senate Bill. The proposed amendment ultimately failed (29-71).

[13] See N. Boidman, "Trump's CIT Rate — Illusion?" *Canadian Tax Highlights* Volume 25, Number 6, June 2017

[14] For example, Alaska, California, Connecticut, Delaware, Iowa, Louisiana, Minnesota, New Jersey, Pennsylvania, Maine, Maryland, Massachusetts, New Hampshire, and Vermont have corporate income tax rates in excess of 8%.

[15] For example, New York City and Philadelphia.

Tightened Interest Deductibility Limitations

The Proposals introduce two sets of rules designed to limit a U.S. corporation's deduction in respect of interest: (1) a general limitation applicable to all corporations and (2) an additional limitation specially aimed at large MNEs.

Current s. 163(j) limits the deduction of interest expense paid by a U.S. corporation, or a foreign corporation with income effectively connected with a U.S. trade or business ("**ECI**"), if:

(1) the interest is paid or accrued to a related party;

(2) the related party pays no U.S. tax on the interest;

(3) the payor's debt-to-equity ratio exceeds 1.5:1 (i.e., the Safe Harbour provision); and

(4) the payor's interest expense exceeds 50% of the payor's modified EBITDA called "adjusted taxable income".[16]

The Proposals would completely replace s.163(j). The new rule would be of much broader application and, significantly, will not contain the Safe Harbour provision and will limit the deduction for net interest expense[17] incurred by a business to 30% of its ATI.[18] Unlike its predecessor, new s.163(j) would apply to "business interest" more generally and to *all* payments, whether made by a foreign or a domestic corporation. Any interest disallowed under new s.163(j) can be carried forward for five years under the House Bill and indefinitely under the Senate Bill.

In addition to general interest limitation, the House Bill proposes to introduce a new world debt cap interest limitation applicable to members of a large MNE that is an "international financial reporting group".[19] If enacted, new s.163(n) would limit the interest expense deduction by taking into account the entire IFRG's interest expense and its EBITDA. Specifically, interest deductibility would be limited to the extent that a U.S. member's *pro rata* share of the "global net interest expense"[20] exceeds 110% of the U.S. persons *pro rata* share of EBITDA.

The Senate Bill contains a similar limitation by reference to a "worldwide affiliate group".[21] The primary difference between both versions is the manner in which the interest deduction limitation is determined. Under the Senate Bill, the limitation is determined by multiplying net interest expense times the "debt-to-equity differential percentage" of the WAG in question. In other words, the formula compares the excess domestic indebtedness[22] to the total indebtedness of all domestic corporations, such that all U.S. members of a particular WAG will be treated as a single member for purposes of determining the limitation.[23]

The 30% of EBITDA rule in new s.163(j) alone will severely curtail the tax benefits of interest-bearing debt financing,

[16] Code, s.163(j)(6)(A); Adjusted taxable income ("**ATI**") refers to the payor's taxable income computed without regard to deductions for net interest expense, net operating loss carry backs or carry forwards, depreciation and depletion and with certain other adjustments.

[17] Code, s.163(j)(6)(B): Net interest expense is the sum of all interest paid or accrued during the taxable year less any interest income reported as gross income for the year.

[18] House Bill, s.3301 and s.3303. The definition of ATI in the Senate Bill however, does not provide for an adjustment with respect to depreciation and amortization. As a result, ATI would be lower under the Senate Bill, therefore generating a greater interest limitation.

[19] House Bill, s.4302; Specifically, an International Financial Reporting Group ("**IFRG**") is defined as: (1) a group of entities that includes at least one foreign corporation engaged in a trade or business in the United States, *or* at least one domestic corporation and one foreign corporation, (2) the group reports its earnings on a consolidated basis, and (3) generates annual gross global receipts of more than $100 million.

[20] That is, the excess of the group's global interest expenses over the group's global interest income.

[21] A Worldwide Affiliated Group ("**WAG**") is one or more chains of corporations, connected through stock ownership with a common parent. The WAG is defined by reference to the Code's current definition of an "affiliated group", at s.1504 of the Code, subject to the following two exceptions: (1) lowering the threshold amount (both in percentage of votes and total value) from 80% to 50%; and (2) permitting the inclusion of foreign corporations as part of the affiliated group.

[22] The amount by which the total indebtedness of the U.S. members *exceeds* 110% of the total indebtedness those members would hold if their debt-to-equity ratio was proportionate to that of the WAG.

[23] The primary concern with the formulation of the Senate Bill's test is its reliance on debt-to-equity ratio. U.S. members of a WAG prepare their financial statements in accordance with U.S. tax and accounting principles, which is unlikely to be the case for other members of that WAG. Classifying an item as either debt or equity may differ significantly from one jurisdiction to the next and can be influenced by a great number of factors. This issue does not arise in the context of the House Bill as its "test" references to the IFRG's consolidated financial statements, which would ignore any differences resulting from jurisdiction-specific reporting standards. Should the interest limitation provisions under the Senate Bill obtain the force of law, Canadian MNEs may incur significant costs in order to convert existing financial statements to conform with U.S. reporting standards and comply with the new interest limitation rules.

including related-party loans used by Canadian MNEs to finance their U.S. operations. If this were not sufficient, large Canadian MNEs may well be subjected to the further world debt cap limitations in s.163(n). Crucially, a U.S. corporation subject to both the new s.163(j) and s.163(n) limitations will be required to apply the provision resulting in the greatest amount of interest being denied.[24] Ironically, the BEPS-sceptic United States seems to have turned out holier than the Pope with these proposals, adopting a harsher set of interest limitations then those suggested under the BEPS Action 4.[25]

It is important to note that the Proposals do not contain any grandfathering provisions that would apply to existing interest-bearing debt arrangements. As a result, if the Proposals are enacted, any interest expense incurred in 2018 would technically be subject to this new limitation rule. Accordingly, Canadian MNEs must review and potentially restructure the debt financing of their U.S. subsidiaries in very short order.

The Senate's Anti-Hybrid Rules

The Senate Bill proposes the enactment, effective in 2018, of a broad anti-hybrid rule[26] that would deny a deduction for any "disqualified related party amount" which has been paid or accrued pursuant to a hybrid transaction,[27] or by, or to, a hybrid entity.[28] For this purpose, a disqualified related party amount is any interest or royalty paid or accrued to a related party to the extent that either there is no corresponding inclusion to the related party under the tax law of the related party's country of residency for tax purposes, or such related party is allowed a deduction with respect to such amounts under the tax law of the related party's country of residency.

The proposal grants broad regulatory authority to carry out the purposes of the proposal, including regulations or other guidance providing rules for:

(1) denying deductions for conduit arrangements that involve a hybrid transaction or a hybrid entity;

(2) the application of this proposal to foreign branches;

(3) applying this proposal to certain structured transactions;

(4) denying all or a portion of a deduction claimed for an interest or a royalty payment that, as a result of the hybrid transaction or entity, is included in the recipient's income under a preferential tax regime of the country of residence of the recipient and has the effect of reducing the country's generally applicable statutory tax rate by at least 25%;

(5) denying all of a deduction claimed for an interest or a royalty payment if such amount is subject to a participation exemption system or other system which provides for the exclusion of a substantial portion of such amount;

(6) rules for determining the tax residence of a foreign entity; and

(7) exceptions to the general rule set forth in the proposal.

If implemented, these anti-hybrid rules would render ineffective certain financing arrangements used by Canadian MNEs for purposes of investing in their U.S. operations, while other such arrangements may possibly survive. For instance, one arrangement that seems adversely affected is the "Repo Structure", which involves the Canadian MNE parent acquiring cumulative dividend fixed-value preferred shares (the "**Repo Shares**") of a U.S. subsidiary subject to a forward purchase agreement (i.e., repurchase (repo) agreement). Under current law, this structure is seen for U.S. tax purposes as a loan by the Canadian parent to the U.S. corporation that is secured with the Repo Shares, while for Canadian tax purposes, the Repo Shares are treated as equity. As a result of this characterization mismatch, the United States would allow an interest deduction, while Canada would see dividends paid from exempt surplus. In the event that the Senate's

[24] Any disallowed interest under the House Bill can be carried forward for five years, whereas the Senate Bill provides for an indefinite carry forward.

[25] For a more detailed comparison between the Proposals and BEPS see M. Herzfeld, "New Analysis: The U.S. Congress Does BEPS One Better", *Tax Notes* (21 November 2017) online: www.taxnotes.com.

[26] Senate Bill, s.14223.

[27] A hybrid transaction is any transaction, series of transactions, agreement, instrument or payment treated as interest or royalties for U.S. tax purposes, and which are not so treated for purposes of the tax law of the foreign entity recipient's jurisdiction.

[28] A hybrid entity is any entity which is treated as fiscally transparent for U.S. tax purposes but not so treated for purposes of the tax law of the foreign entity's jurisdiction, or vice versa.

anti-hybrid rules are retained, any interest paid within the framework of such a Repo Structure would be denied, forcing Canadian MNEs to urgently reconsider the viability of such existing structures.

Another arrangement used by Canadian MNEs to finance their U.S. operations is the "Tower", which involves a reverse hybrid partnership (" **LP**") entered into between Canadian members of the MNE group that is the sole shareholder of a Canadian unlimited liability company ("**ULC**") that in turn is the sole member of a U.S. limited liability company ("**LLC**"). The Tower sees the LP borrow from a third party financial institution and invest the proceeds through ULC into LLC, which in turn lends at interest to an operating U.S. subsidiary ("**U.S. Opco**") of the Canadian MNE parent. For U.S. tax purposes, the LP checks the box to be treated as a U.S. domestic corporation so that the U.S. sees a back-to-back financing running from the third party financial institution, through the LP, into the U.S. Opco. Canada in turn sees a fiscally-transparent LP that allows for interest deductions to flow up to the Canadian partners, while the interest paid by U.S. Opco to LLC is recharacterized into active business income that can be paid to ULC as exempt surplus dividends. In the event that the Senate's anti-hybrid rules are enacted, it is not clear that the Tower will be adversely affected. Payments by the reverse hybrid LP will be made to an unrelated financial institution, while payments made to the LP from the related U.S. Opco will be fully includable in the U.S. taxable income of LP.

Finally, various Canada to U.S. financing arrangements using third countries, such as Luxembourg, that use "plain vanilla" non-hybrid interest-bearing loans into the United States, may also not be subject to these anti-hybrid proposals. It is to be seen whether any regulations adopted with respect to these anti-hybrid rules would expand their scope and apply to such other financings.

Other Anti-Base Erosion Proposals

The House Bill includes a drastic proposal to introduce a 20% excise tax on deductible payments made by U.S. corporations to related foreign members of the same group.[29] Similar to the rules imposing additional interest expense limitations, the excise tax will only apply to payments made by U.S. members to foreign corporations within the same IFRG and totaling at least $100 million annually.

The excise tax is applied on the gross amount of the deductible payment in question, and such tax is neither creditable, nor deductible by the U.S. corporation. Deductible payments with respect to a U.S. corporation is broadly defined as amounts generally deductible, amounts included as part of cost of goods sold, or amounts included in the cost base of depreciable assets. Deductible payments would not include, however, interest payments, amounts paid or incurred with respect to the acquisition of a security or a commodity, and payments for services at cost (i.e., no mark-up). There is also an exception with respect to payments that were subject to the full U.S. withholding rate at 30%.[30]

Significantly, the foreign member of the IFRG may elect to treat its income that is subject to the excise tax as ECI attributable to a permanent establishment. If such an election is made, the foreign member would be subject to U.S. federal income tax on a net basis rather than the default gross basis. In addition, the electing entity can claim up to 80% of the taxes paid in its foreign jurisdiction.

The Senate Bill does not contain an exact equivalent to the House's excise tax, but contains a measure, that pursues a broadly similar objective, called Base Erosion Minimum Tax ("**BEMT**").[31] The BEMT would only apply to taxpayers with annual gross receipts in excess of $500 million that made deductible payments to related parties equivalent to 4% or more of the sum of all deductible expenses. Similar to the newly-repealed corporate AMT regime, the BEMT will apply if 10% of the corporation's modified taxable income (i.e., taxable income plus any base-eroding payments) is greater than its regular tax liability.[32]

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[29] House Bill, s.4303. There is no parallel proposal under the Senate Bill, but see discussion below regarding Senate's Base Erosion Minimum Tax. See Nathan Boidman, "U.S. Tax Reform Bill Goes Too Far in Addressing Abusive Transfer Pricing" Tax Notes Int'l, December 4, 2017, p. 991.

[30] In the event that a tax treaty reduces the withholding rate applicable to a deductible payment, the excise tax would be applied proportionately to the amount not subject to full withholding tax.

[31] Senate Bill, s.14401.

[32] In that regard, a base erosion payment generally means any amount paid or accrued by a taxpayer to a foreign person that is a related party of the taxpayer, and with respect to which a deduction is allowable, including any amount paid or accrued by the taxpayer to

(continued on next page)

Obviously, the House Bill's proposed excise tax and elective ECI regime is a blatant treaty override that seems broadly inspired from the border adjusted tax of earlier Republican tax proposals. If enacted, but for the 80% foreign tax credit this rule would have extremely harsh consequences on Canadian MNEs supplying goods and services to their U.S. operations. The Senate Bill is conceptually more reasonable and is narrower in scope,[33] though it would also have far-reaching consequences for Canadian MNEs with U.S. operations. Considering that both the House and Senate proposals could also have material adverse consequences for U.S. multinationals in the outbound context it is yet to be seen whether any of these rules will survive reconciliation.

Conclusion

This article has provided a brief overview of some of the challenges Canadian MNEs will face should any of the Proposals make their way into legislation – an endeavour the JCT is keen on completing before December's congressional recess. Despite the Republicans' eagerness however, the Proposals are still a long way from becoming law. Both chambers of Congress must still approve identical legislative language. The JCT, comprising delegates from both the Senate and the House of Representatives, has the responsibility of reconciling inconsistencies between the House Bill and the Senate Bill. The common version of the Proposals is then voted on for a second time. If the requisite number of votes is obtained in both chambers of Congress, the legislation is brought to the President for his signature.

Of course, there is no way of knowing for certain which of the provisions in the Proposals will be retained, modified, or discarded. As of the date of this article, the JCT has only been able to resolve a few differences between the House Bill and Senate Bill, such as the top individual rate of tax (37%), corporate tax rate (21%), the repeal of the corporate AMT regime and the taxation of pass-through entities. What can be said for certain though is that if some form of the above Proposals is enacted, they would very likely significantly change the manner in which Canadian MNEs structure and finance their operations in the United States.